

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 06-0155
Sales and Use Tax for 2004

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ISSUE

I. Sales/Use Tax—Assessment on Purchase of Aircraft

Authority: IC 6-8.1-5-1(b); IC 6-2.5-3-2; IC 6-2.5-3-6(d)(2); IC 6-2.5-5; IC 6-2.5-3-4; IC 6-2.5-5-8(a) and (b); IC 6-6-6.5-2; IC 6-2.5-4-10(a) and (b); IC 6-2.5-2-1; IC 6-2.5-2-1; Form 7695; Indiana Dept. of State Revenue v. Interstate Warehousing, 783 N.E.2d 248 (Ind. 2003); Gregory v. Helvering, 293 U.S. 465 (1935); Horn v. Commissioner, 968 F.2d 1229 (D.C. Cir. 1992).

Taxpayer protests the assessment of sales and use tax on the purchase of an aircraft.

STATEMENT OF FACTS

Taxpayer is a limited liability company with a single member. It purchased an aircraft on 12/21/2004 for \$614,205. The aircraft was sold by a related entity LLC to Taxpayer. The member of the seller is the same person as is the member of the purchaser, Taxpayer. The AFFIDAVIT OF AIRCRAFT SALE, executed by the seller, and Form 7695, APPLICATION FOR AIRCRAFT REGISTRATION OR EXEMPTION, which registered the aircraft with the Department, both certify the purchase date of 12/21/2004. On Form 7695, Taxpayer claimed an exemption from sales and use tax for rental or lease to others.

On 8/16/2004, four months before Taxpayer owned the aircraft, it entered into a non-exclusive agreement to lease the aircraft to its president/member. The agreement was an hourly rental agreement which could be terminated at the will of the parties at any time.

On 9/15/2004, three months before it owned the aircraft, Taxpayer entered into a non-exclusive six month lease with a third-party lessee. This agreement is recorded as HOURLY RENTAL AGREEMENT. Another document, LEASE LETTER OF AGREEMENT, states that the lease agreement with the third-party is exclusive. The terms stated in this document were specified 30-day increments beginning on 9/1/2004 with automatic 30-day extensions unless one party informed the other of a cancellation of the lease. The lease terms stated that Taxpayer was responsible for all operating expenses of the aircraft, including fuel and oil. The full costs of insuring the aircraft were to be borne by Taxpayer and were to be paid to the third-party lessee. The terms of the lease indicated that the lessee was permitted to rent the aircraft to others not party to the agreement, the lessee was permitted to use the aircraft for flight training, and the lessee was permitted to use the aircraft for its own company use.

The Department denied Taxpayer's sales and use tax exemption, finding there was insufficient evidence to support the claim that Taxpayer was in the business of rental or leasing. Sales and use tax were assessed. A protest was filed and a hearing was held.

I. Sales/Use Tax—Assessment on Purchase of Aircraft

DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b).

Taxpayer purchased an aircraft on 12/21/2004. IC 6-2.5-3-2 imposes an excise tax, commonly known as the use tax, on the storage, use, or consumption of an aircraft if the aircraft (1) is acquired in a transaction that is an isolated or occasional sale; and (2) is required to be titled, licensed, or registered by this state for use in Indiana. In the case of aircraft, taxpayers are to pay the tax directly to the Department when registering the aircraft unless the aircraft qualifies for an exemption. IC 6-2.5-3-6(d)(2).

Exemptions to the imposition of sales and use tax exist. *See* IC 6-2.5-5 and IC 6-2.5-3-4. IC 6-2.5-5-8(b) exempts from sales tax, property acquired for resale, rental, or leasing in the ordinary course of the person's business. The Indiana Supreme Court has stated:

It is well established that exemption statutes are strictly construed against a taxpayer so long as the intent and purpose of the Indiana Legislature is not thwarted. As such, a taxpayer has the burden of establishing its entitlement to an exemption.

Indiana Dept. of State Revenue v. Interstate Warehousing, 783 N.E.2d 248, 250 (Ind. 2003).

IC 6-6-6.5-2 requires an Indiana resident to register his aircraft with the state through the Department within 31 days of the purchase date. Taxpayer filed Form 7695, APPLICATION FOR AIRCRAFT REGISTRATION OR EXEMPTION, and claimed in Section D, a sale and use tax exemption for "Rental or Lease to others."

IC 6-2.5-4-10(a) states that the rental or leasing of tangible personal property to another person is a retail transaction. In accord with IC 6-2.5-2-1, sales tax is to be imposed on the rental of the aircraft by Taxpayer to others. This means that sales tax is to be collected by Taxpayer from the third-party lessee and from Taxpayer's president/member when each uses Taxpayer's aircraft.

Rental of the Aircraft by Taxpayer to its member

Taxpayer claims it is entitled to a sales and use tax exemption because it is engaged in the rental of the aircraft to others. Rental of the aircraft to its own president/member is not rental to others; it is rental to itself. The member has a need for an aircraft for his personal use. If the member had purchased the aircraft outright, sales or use tax would have been due because no applicable tax exemption could be leveraged. But if the aircraft is purchased through an entity owned and controlled by the member, the company can hold the asset and can lease the aircraft back to its own member. By claiming to "rent" the aircraft to the member, the person can avoid the upfront

imposition of the substantial sales tax. When the transaction is collapsed, the member of the Taxpayer LLC enjoys the use of the aircraft, but has avoided paying the sales tax in a lump-sum. Because the Taxpayer LLC is a pass-through entity, the member reaps to himself all the tax benefits of depreciation and operating expenses.

Application of the Sham Transaction Doctrine

The lease agreement falls squarely within the doctrine of sham transaction. The sham transaction doctrine is well established in state and federal tax jurisprudence. In Gregory v. Helvering, 293 U.S. 465, 469 (1935), the United States Supreme Court held that in order to qualify for a favorable tax treatment, a corporate reorganization must be motivated by the furtherance of a legitimate corporate business purpose. A corporate business activity undertaken merely for the purpose of avoiding taxes was without substance and to hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose. *Id.* at 470. Transactions invalidated by the sham transaction doctrine are those motivated by nothing more than the taxpayer's desire to secure the attached tax benefit but are devoid of any economic substance. See Horn v. Commissioner, 968 F.2d 1229, 1236-37 (D.C. Cir. 1992).

The relationship between Taxpayer and the member is interfamilial. This is not rental and leasing to others; it is renting and leasing to itself. On the lease document, the president/member who signed for Taxpayer as lessor is the same person who signed as lessee as an individual. There is no arms-length transaction between different parties; this is the one and the same person benefiting.

Rental of the Aircraft to the Third-party Lessee

IC 6-2.5-2-1 imposes sales tax on retail transactions and requires the merchant, as an agent, to collect and remit those funds to the State. Renting and leasing is a retail transaction. IC 6-2.5-4-10(b). IC 6-2.5-8-8(a) relieves a merchant from the duty to impose, collect, and remit sales tax to the State when the purchaser presents a valid sales and use tax exemption certificate contemporaneous to the retail transaction. Taxpayer was required to collect sales tax from the third-party lessee on each rental payment.

Taxpayer asserts that the third-party lessee was engaged in public transportation. The Department acknowledges that the third-party lessee has a Part 135 Public Transportation certificate issued by the FAA secured on the aircraft. But Taxpayer has glossed over the sales tax transaction. The lessee may be able to claim a public transportation exemption and it would do so on a valid sales and use tax exemption form that it would present to Taxpayer. But Taxpayer may not claim that exemption on behalf of the third-party lessee. The lessee would need to claim it and would do so by presenting Taxpayer with a valid sales and use tax exemption certificate. Taxpayer points to the Part 135 certificate as proof that the aircraft was used in an exempt manner. But under the sales and use tax statutes, presenting the Part 135 certificate is not the requirement. Taxpayer is mistaking its role as merchant, thinking it may stand in the shoes of the lessee purchaser. The sales and use tax statutes do not grant merchants that status. Taxpayer was to have collected and remitted sales tax on the rental payments received from the third-party lessee.

After being granted a one week extension after the hearing to present documentation, Taxpayer submitted a photocopy of Form ST-105 (Rev 1/00), INDIANA DEPARTMENT OF REVENUE GENERAL SALES TAX EXEMPTION CERTIFICATE, with the third-party lessee listed upon the face as claiming the exemption. The timing of the presentation of the document to the Department places into question the validity of the document. Taxpayer had been prompted for months to provide documentation, and it was only after the hearing that Taxpayer produces the exemption certificate. During the hearing, Taxpayer repeatedly attempted to establish that it did not need to collect sales tax from the third-party lessee by presenting the lessee's FAA Part 135 public transportation certificate. Not once during the hearing did Taxpayer establish that it had a sales tax exemption certificate from the third-party lessee.

Additionally, the terms of the lease with the third-party lessee, HOURLY RENTAL AGREEMENT, indicate that this is not a true charter arrangement. The terms of the lease signed September 15, 2004, call for the lessee to subtract fuel, maintenance, insurance, and other services. This does not appear to be a lease for charter, but a lease-back to Taxpayer. The lease in section 7.2 states:

This clause will not apply to the months of April or May 2001, but rather will commence with the calculation of rent for the month of June 2001 payable in July 2001.

This lease was not signed, nor do any of the terms indicate that there was an effective lease period reaching back to 2001. Taxpayer did not own the aircraft until 2004. The Department gives little weight to this document purporting to establish a lease to others.

The third-party lessee did not begin charter flights until June 28, 2005. For the first six months of ownership, Taxpayer was leasing the aircraft to its own member. As discussed above, this is not renting and leasing to others; this is rental and leasing to itself.

The Irregularity of the Ownership of the Aircraft

Taxpayer claims ownership of the aircraft as of August 16, 2004. At the hearing Taxpayer was asked to explain the conflict of dates, but was unable to do so. After the hearing, Taxpayer submitted a letter stating that the bill of sale was prepared by someone else, who inserted the wrong date on the document. The letter is unconvincing. The representative for the seller and the purchaser, Taxpayer, are the same person. That person stated in the affidavit of aircraft sale:

I [person], member of [Seller LLC] ("Seller"), do hereby swear and affirm that on the 21st day of December, 2004, in consideration of the receipt of Six Hundred and Fourteen Thousand Two Hundred and Five Dollars (\$614,205.00), I did sell, transfer, and assign all right, title and interest in the above-described Aircraft to [Taxpayer LLC] ("Purchaser").

Given the brevity of the recitation of terms and the fact that the representative for the purchaser and seller the same person, the Department must question the validity of the explanation. Additionally, assuming *arguendo*, that Taxpayer's assertion is correct, then Form 7695 would have needed to be submitted to the Department within 31 days of the August 16, 2004, purchase date—by September 17, 2004. The Department did not receive Form 7695 from Taxpayer until

January 19, 2005. This supports and documents a purchase date of December 21, 2004, because that would be a timely submission of Form 7695.

Entering into a 30-day renewable lease with the third-party lessee three months before owning an aircraft and entering into a lease with the member four months before owning an aircraft would appear to defy common sense and common business practice. Taxpayer has not sufficiently documented an exemption from sales and use tax on the purchase of the aircraft.

FINDING

For the reasons stated above, Taxpayer's protest is denied .

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